Supreme Court, U. S.
FILED
OCT 19 1978
MICHAEL RODAK JR., CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1978

No. 78-660

PLEASANTON GRAVEL COMPANY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF
APPEALS FOR THE NINTH CIRCUIT

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Pleasanton Gravel Company, Petitioner herein, prays that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit, entered in the above-entitled case on July 21, 1978.

CITATIONS TO OPINIONS BELOW

The opinion of the Tax Court of the United States is reported at 64 T.C. 510 and is reproduced in Appendix A hereto. The opinion of the Court of Appeals for the Ninth Circuit is currently not officially reported. It is unofficially reported in

78-2 U.S.T.C. ¶9616, and is reproduced in Appendix B hereto.

JURISDICTION

The judgment of the Court of Appeals was made and entered on July 21, 1978. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

QUESTION PRESENTED

Was the Tax Court's determination that petitioner's unconditional conveyance of mineral rights was a lease rather than an outright sale, clearly erroneous in view of the written agreement evidencing the sale and the parties conduct subsequent to the sale?

STATEMENT OF THE CASE

Petitioner is a California Corporation organized on August 15, 1956, for the primary purpose of selling rock, gravel and sand.

On or about January 1, 1959, petitioner contracted with another company for the sale and purchase of rock, sand and gravel on petitioner's Pleasanton property. The exact quantity of the minerals on the property was estimated on the basis of the then known technology. The parties therefore agreed for the conveyance of "ALL the rock, sand and gravel" on the land. The buyer was obligated, in return, to pay to petitioner an amount equal to the wholesale price on the gravel market in the area for the amount extracted as determined by outside parties.

The agreement was to last until all the gravel had been extracted. The parties provided for termination only in the event of unforeseen circumstances which would defeat the stated objectives of the agreement and therefore, make continued performance commercially unreasonable. In addition, 60 days notice was required for termination.

The parties commenced performance according to the terms of the agreement soon after it was entered into and continued to perform, faithful to the terms of the agreement, until all the rock, sand and gravel had been extracted. Although the original quantity estimate was 3,000,000 tons, the buyer extracted 14,000,000 tons due to the acquisition of technically advanced machinery that enabled it to greatly increase the total yield.

When the quarry was closed in the fall of 1973, all commercially mineable rock, sand and gravel had been mined and the deposit exhausted.

Petitioner filed a petition to the Tax Court in response to a statutory Notice of Deficiency issued by the Commissioner of Internal Revenue for deficiencies assessed in federal personal holding company taxes for the taxable years ending October 31, 1967, 1968, and 1969.

Relying on Palmer v. Bender, 287 U.S. 551 (1933), the Tax Court held that the unconditional conveyance made by the petitioner of all rock, sand and gravel on the Pleasanton property was a lease rather than a sale; therefore, the proceeds received were ordinary income rather than capital

gains and were includable as personal holding company income under Section 543(a)(3) of the Internal Revenue Code of 1954. The Court of Appeals for the Ninth Circuit, in a per curiam decision, affirmed the Tax Court's decision.

REASONS FOR GRANTING THE WRIT

The decision below on the question of whether or not petitioner's conveyance of mineral rights was a sale or a lease is in conflict with the decision of this Court in Palmer v. Bender, 287 U.S. 551 (1933), with the Court of Appeals for the Fifth Circuit in Rhodes v. U.S., 464 F. 2d 1307 (1972) and with the Court of Appeals for the First Circuit in Linehan v. Commissioner, 297 F. 2d 276 (1961).

AN UNCONDITIONAL CONVEYANCE OF ALL GRAVEL IN PLACE IS A SALE IN SUBSTANCE AS WELL AS FORM

Despite the fact that the Tax Court's summary of the facts in its opinion below ignored the clear sales import of petitioner's conveyancing agreement by omitting the relevant paragraph, said paragraph establishes to a certainty that a sale of "all" had occurred:

> "Now therefore, Seller does hereby sell and grant to Buyer forever all the rock, sand and gravel deposits in, on and under the lands described in "Exhibit A" together with the full right to enter upon, quarry and remove from the premises described in "Exhibit A" all the rock, sand and gravel..." (Emphasis added)

When the above paragraph is read in light of the subsequent acts of petitioner and the buyer, to label the transaction as anything but an outright sale is to fly in the face of reality. The buyer, over a period of approximately 14 years, extracted 14,000,000 tons of minerals -- almost five times the original quantity estimate. The only reason the parties closed the quarry in the Fall of 1973 is that the land had been exhausted; all the commercially mineable gravel had been extracted.

The Court of Appeals in its decision below distortedly applies the "economic interest" test as stated in Palmer v. Bender, supra, and concludes that petitioner has retained such an interest and therefore, the conveyance is to be characterized as a lease. While the Palmer test has amassed considerable support over the last 45 years, it is crucial that one take note of the factual differences between Palmer and petitioner's case. Immediately upon doing so it is undeniable that the Palmer test is not only inapplicable to petitioner's case, but as originally stated was never meant to be applied where an unconditional sale of "all" has occurred.

Palmer and its progeny dealt with owners of unimproved land laden with minerals, who desired to avail themselves of the best of two worlds. Armed with a healthy depletion allowance one could transfer less than all of his interest in the minerals, receive a percentage of the profits in the form of royalties, offset this gain with the depletion allowance and still retain a significant share of future resale profits arising from market conditions,

increased quantities discovered on the land and the like.

That the "economic interest" test as defined in Palmer and its progeny is inapplicable to petitioner's case is implicit from this Court's decision in Palmer; unlike petitioner, the one eighth excess royalty retained by the taxpayer in Palmer was found to represent an unconditionally retained right to future profits. In essence, the test was created to deal with a taxpayer who had not transferred "all".

The inapplicability of the "economic interest" test to petitioner's case is further emphasized in Linehan v. Commissioner, supra, and Rhodes v. U.S., supra.

In Linehan the taxpayer conveyed all the minerals on his land down to a specific height corresponding to street access to the land. The price was fixed per cubic yard and a quantity estimate was made at the outset. Similarly, in Rhodes, the taxpayer conveyed all the merchantable clay on his land without retaining any possibility of sharing in future profits. In both of these cases, a sale of all the minerals was held to have occurred.

Petitioner's case is identical to Linehan and Rhodes; there has been an outright sale of all minerals in place completely divesting petitioner of any right to share in profits resulting from the buyer's future sales.

SUMMATION

In accordance with the initial terms of petitioner's conveyance the actual performance of the agreement by petitioner and the buyer conclusively establishes an unconditional sale of all the gravel on petitioner's land. From the outset both parties intended that the transfer of "all" was to be interpreted according to the recognized usage of the term -- a transfer of petitioner's "total" interest in the gravel in place "without any exceptions". (Webster's New World Dictionary, College Edition, p. 38). The parties subsequent performance over a period of approximately 14 years reconfirms this initial intent: petitioner never once partook of any of the buyer's resale profits.

In short, it is readily apparent that from the date the agreement was entered into until the gravel deposits were exhausted in 1973 petitioner no longer retained any economic interest in the gravel on his land.

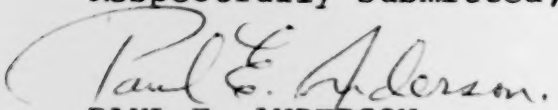
As the circumstances in the case at bar are for all critical purposes identical to those in Linehan v. Commissioner, supra, and Rhodes v. U.S., supra, and because the decision of the Court below conflicts in principal with these decisions, and since the Court below misinterpreted and misapplied this Court's holding in Palmer v. Bender, supra, this Court should grant this petition in order to resolve the conflict presented.

CONCLUSION

For the foregoing reasons, this petition for a Writ of Certiorari should be granted.

Dated: September 19, 1978.

Respectfully submitted,



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APPENDIX A

64 T.C. 510

UNITED STATES TAX COURT

PLEASANTON GRAVEL COMPANY, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 6095-73. Filed June 30, 1975.

T. Corp. entered into a contract under which J Co. had the right to remove sand and gravel from T Corp.'s property, and which, as construed herein, did not require it to remove all or any specified portion thereof. J Co. undertook to pay for the sand and gravel removed at a price per ton geared to the wholesale selling price of sand and gravel then prevailing in the local market during the month such sand and gravel was removed. Held, T Corp. did not sell its minerals "in place" but rather received royalty payments which constituted personal holding company income on account of which T Corp. was a personal holding company. Secs. 542(a)(1), 543(a)(3) and (b)(1), I.R.C. 1954. Held further, because T Corp. failed to file with its return the schedule required by Sec. 6501(f), I.R.C. 1954, the applicable period of limitation upon the assessment of taxes, as explicitly provided for in Sec. 6501(f), was six years. Held further, the words "CLOSED ON SURVEY" stamped on the face of T Corp.'s tax returns indicated merely that in the process of "classification" of those returns they were not selected for audit (or "examination"), with the consequence that an examination conducted thereafter was not a second

"examination" within the meaning of Sec. 7605(b), I.R.C. 1954, nor did it constitute a reopening of cases closed after "examination" within the meaning of Sec. 601.105(j), Proced. & Admin. Regs. There was no procedural defect that would prevent the determination of deficiencies in respect of these returns.

Paul E. Anderson, for the petitioner.

William E. Saul and James Booher, for the respondent.

RAUM, Judge: The Commissioner determined deficiencies in petitioner's Federal income taxes in the following amounts:

Taxable Year Ended	Deficiency
October 31, 1967	$23,570.73
October 31, 1968	21,570.17
October 31, 1969	26,133.00

The ultimate issue in this case is whether petitioner is a personal holding company subject to the personal holding company tax imposed by section 541, I.R.C. 1954. The only substantial question bearing on this issue is whether pecitioner's receipts from the sale of its sand and gravel deposits constituted royalty income or long term capital gain. In addition to the substantive issue herein, there are presented two questions pertaining to the procedures followed by the Commissioner: (1) is the Commissioner barred from the assessment and collection of the deficiencies herein due to the expiration of the applicable period of limitations, and (2) do the words "CLOSED ON SURVEY", stamped on the face of

petitioner's returns by the Commissioner, indicate that the Commissioner conducted an examination of petitioner's books of account within the meaning of section 7605(b) or that the case was closed within the meaning of section 601.105(j). Proced. & Admin. Regs., as a result of which further examination by the Commissioner was barred?

FINDINGS OF FACT

The parties have stipulated most of the facts, and their several stipulations, together with accompanying exhibits, are incorporated herein by this reference.

Pleasanton Gravel Company ("petitioner") is a California corporation. At the time of filing its petition herein, its principal office was in Oakland, California.

Following its incorporation in 1956, petitioner issued 800 shares of $25 par stock to George W. Jamieson in return for $20,000. He has since remained petitioner's sole stockholder. Shortly thereafter petitioner acquired 173 acres of land ("Pleasanton property") situated in the Livermore Valley near Pleasanton, California, from George W. Jamieson for $18,000. On January 1, 1959, petitioner entered into an agreement concerning the sand and gravel deposits on its property with Jamieson Company, a partnership consisting of George W. Jamieson and, for the years here in issue, his father, George G. Jamieson, as equal partners. By that agreement petitioner purported to "sell and grant to Buyer [Jamieson Company] forever, all the rock, sand and gravel deposits in, on and under"

the therein described portion of the Pleasanton property. Pertinent terms and conditions of agreement were as follows:

> 1. Buyer shall have the right to operate upon the premises described in "Exhibit A" hereto such number of gravel pits and quarries as may be proper under approved quarrying procedures and to excavate and remove from the said premises such rock, sand and gravel as may be proper and profitable under good quarrying practices.* * *
>
> Buyer shall operate its gravel pits and quarries upon said premises in accordance with good quarrying practices and shall not abandon any gravel pit or refill the same with over-burden or dirty water until Buyer in its judgment determines that all rock, sand and gravel that can profitably be recovered therefrom under good quarrying practices has been removed.
>
> 2. The Seller makes no warranty to Buyer as to the amount of rock, sand and gravel that may profitably be quarried in, on or under the lands * * *. however, if the water table should fall below one hundred (100) feet, Buyer may expect to profitably remove three million (3,000,000) tons of rock, sand and gravel from the deposits herein sold to Buyer.
>
> 3. The Buyer shall pay to Seller for every ton of rock, gravel or sand removed by Buyer, a specific amount for each ton so removed by Buyer. The price to be paid by Buyer for each ton so removed will depend on the average

wholesale selling price in Pleasanton, California, during the month of removal for the materials so removed. Attached hereto as "Exhibit B" is a schedule setting forth the price that will be payable by Buyer for each ton of rock, gravel or sand removed (Column II) based on the base wholesale price per ton in Pleasanton, California, for rock, gravel and sand (Column I).

Buyer shall deliver to Seller a report in writing showing the number of tons of gravel, rock and sand removed from said premises during the preceding month on or before the 15th day of the calendar month next succeeding the calendar month in which Buyer makes its first removal of gravel, rock or sand from said premises and shall deliver to Seller a like report on or before the 15th day of each calendar month thereafter that Buyer is conducting quarry operations on the premises, and Buyer shall pay to Seller a sum equal to the total purchase price for all gravel, rock and sand as shown in the report due on the 15th day of the preceding month.

4. If at any time during quarrying operations Buyer determines that rock, gravel and sand can no longer be profitably quarried and removed from the lands described in "Exhibit A" hereto, Buyer shall have the option to terminate this agreement upon sixty (60) days notice to Seller.

* * * * *

6. Buyer may erect upon the lands particularly described in "Exhibit A"

hereto such machinery, trackage and buildings roads [sic] as it may deem necessary or convenient for the proper and economical operation of the gravel pits and quarries upon said premises. * * *

* * * * *

9. Buyer shall keep the lands * * * free from any liens arising out of any work performed for, materials furnished to or obligations incurred by Buyer.

10. Buyer shall, at its sole cost and expense, comply with all the requirements of all Municipal, State and Federal authorities now in force or which hereafter may be in force pertaining to its operations upon said premises, and shall faithfully observe in its operations on said premises all Municipal ordinances and State and Federal statutes now in force or which may hereafter be in force. * * *

The attached Schedule B referred to in paragraph 3 of the agreement provided that petitioner was to be paid a minimum of $.05 per ton of rock, sand and gravel removed plus an additional $.01 per ton for each $.30 (or part thereof) increment in the wholesale selling price above $1.50 per ton. Thus, for example, if the per ton wholesale selling price of rock, sand and gravel was $1.90 per ton, petitioner was entitled to receive $.07 per ton from Jamieson Company; if it were $2.20 per ton, petitioner would receive $.08 per ton, and so on. This payment schedule was amended on January 1, 1962, to provide that -

> In event [sic] and whenever one million (1,000,000) or more tons of Rock, Sand and Gravel is sold by Pleasanton Gravel Company to Jamieson Company in any one calendar year then the purchase price to be paid shall be reduced 20% as applied to Exhibit B * * *.

Under this agreement, Jamieson Company mined the sand and gravel which it then processed with machinery located on the same property. The processing consisted of washing, sizing, screening, crushing, and stockpiling the various materials mined. Jamieson Company thereupon sold these materials to Rhodes-Jamieson, Ltd., a corporation which, for the years in issue, also was owned by George W. Jamieson and his father, 49 percent and 51 percent, respectively. Rhodes-Jamieson, Ltd., used the gravel and sand both for ready mix concrete and for sales to third parties. Neither petitioner nor Jamieson Company had any employees; instead, they each paid a fee to Rhodes-Jamieson, Ltd., to perform their respective activities, including the operation of the processing machinery. In addition, Jamieson Company leased the processing machinery from Rhodes-Jamieson, Ltd.

Petitioner's primary source of income since its incorporation has been the proceeds received from Jamieson Company, pursuant to their agreement. Despite their estimate in the agreement that Jamieson Company would be able to remove a total of 3,000,000 tons of material, Jamieson Company in fact removed over 14,000,000 tons by the close of petitioner's fiscal year which ended in 1969, and more than an additional 4,000,000 tons before exhausting the

available supplies in 1973 (other than those beneath the area which Jamieson Company used for processing). As a result of Jamieson Company's mining activity, the portion of the Pleasanton property from which deposits had been removed was left covered with water which, due to the high level of the water table, could not be drained away.

For each of its taxable years in issue, petitioner filed a Federal Corporation Income Tax Return, Form 1120. On none of those returns did it indicate in the space provided that it was a personal holding company nor did it attach thereto a separate schedule showing its gross income, adjusted ordinary gross income and the names and addresses of its stockholders. Petitioner stated on each return that its principal business activity was "Gravel Mining & Sales", and it reported income and expenses for the years in issue as follows:

Description

Income	10/31/67	10/31/68	10/31/69
Gravel sales	$67,776.93	$71,143.41	$81,654.00
Rental income	1,000.00	1,000.00	1,000.00
Interest income	7,430.50	9,225.00	9,225.00
Total Income	$76,207.43	$81,368.41	$91,879.00

Expenses	10/31/67	10/31/68	10/31/69
Repairs	-0-	$ 7,334.62	$ 200.00
Rents	$ 1,000.00	1,000.00	1,000.00
California Franchise Taxes	2,182.35	3,722.82	3,428.00
Property Taxes	12,228.76	14,337.32	13,917.00
Depreciation	2,606.98	4,345.86	8,016.00
Depletion	3,388.85	3,557.17	4,083.00
Professional Services	630.00	625.00	685.00
Outside Office Services	1,200.00	1,200.00	1,200.00
Total Expenses	$23,236.94	$36,122.79	$32,529.00
Taxable Income	$52,970.49	$45,245.62	$59,350.00

Pleasanton had adjusted gross income and adjusted gross income from gravel transfers for the years in issue as follows:

	Tax Year Ended		
	10/31/67	10/31/68	10/31/69
Adjusted gross income [1/]	$54,800.49	$54,405.24	$61,435.00
Adjusted gross income from gravel transfers	47,369.99	45,180.24	52,210.00

1/ Although the parties' stipulation referred to "Adjusted ordinary gross income", we assume this was inadvertent

On its Federal income tax returns for these years, petitioner reported its income from the gravel transfers on the line entitled "Gross receipts or gross sales." In its returns for prior years, petitioner had at times reported such income as "royalties". In each of its taxable years ended in 1960 through 1969, petitioner deducted from its income a depletion allowance in an amount equal to five percent of its gross income from gravel transfers. In none of the years at issue or prior thereto did petitioner treat the gravel related income as capital gains. Also, there is no evidence that petitioner paid any dividends during these years.

Petitioner filed its Federal income tax returns for the first two taxable years in issue with the district director of internal revenue at San Francisco, California; for the remaining taxable year in issue it filed with the Western Service Center at Ogden, Utah. Payments or evidences of credits for prior payments were removed and proper credit made thereof. Each return was checked for mathematical accuracy and internal consistency. The return was then accepted as being filed and thereupon delivered to a Classifying Officer of the Internal Revenue Service. It would then be assigned to a Revenue Agent who worked in the classification section. He reviewed each of the returns, and, upon the basis of

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1/ (Continued)

inasmuch as it is the essence of petitioner's case that its gross income from gravel transfers was not includable in its adjusted ordinary gross income.

criteria not disclosed herein, made a determination and ordered a clerk to place the stamp "CLOSED ON SURVEY" or "FIELD AUDIT" on the face of the returns. In accordance with this procedure the returns for the first two of the years here in issue were stamped "CLOSED ON SURVEY" while the return for the taxable year ended in 1969 was marked with the imprint "FIELD AUDIT". For each of these taxable years, the Commissioner conducted only one actual inspection of petitioner's books and records kept at its home office.

By reason of three Forms 872, executed on behalf of petitioner, the period of limitation upon assessment of income and profits tax for each of the years in issue was extended until June 30, 1973. In the deficiency notice, dated June 25, 1973, the Commissioner determined that -

> Since over 60 percent of your adjusted ordinary gross income * * * [in each of the years in issue] consisted of personal holding company income as defined in section 543, you qualified as a personal holding company under section 542 of the Internal Revenue Code in those years. Accordingly, you are subject to the personal holding company tax under section 541 of the Code.

In its amended petition herein, petitioner claimed refunds for each of the taxable years in issue on account of its alleged error in reporting the amounts received on the sale of gravel as ordinary income instead of capital gain.

OPINION

At issue is whether, for the taxable years before us, petitioner is subject to the personal holding company tax imposed by section 541.[2] The incidence of that tax is reserved for personal holding companies as defined in sections 542-544. The starting point of the irritatingly convoluted[3] statutory path set forth therein is section 542(a),[4] which provides that

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[2] SEC. 541. IMPOSITION OF PERSONAL HOLDING COMPANY TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to 70 percent of the undistributed personal holding company income.

[3] Cf. Commissioner v. Welch, 345 F. 2d 939, 941 fn. 2 (C.A. 5); Fred Frankfort, Jr., 52 T.C. 163, 168; David A. Foxman, 41 T.C. 535, 551, fn. 9, affirmed 352 F. 2d 466 (C.A. 3); Van Products, Inc., 40 T.C. 1018, 1028; Thomas G. Lewis, 35 T.C. 71, 76.

[4] SEC. 542. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) General Rule.-- For purposes of this subtitle, the term "personal holding company" means any corporation (other than a corporation described in subsection (c)) if --

the term "personal holding company" means any corporation (with certain exceptions not relevant here) if (1) at least 60 percent of its "adjusted ordinary gross income" for the taxable year is "personal holding company income", and (2) more than half of its stock is owned by not more than five individuals (with which requirement petitioner admittedly complies). Thus, the critical determinations in this case are the amounts of petitioner's personal holding company income and its adjusted ordinary gross income.

"Personal holding company income" is, by definition, a specified portion of adjusted ordinary gross income",[5/] the

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4/ Continued

(1) Adjusted Ordinary Gross Income Requirement.--At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a)), and

(2) Stock Ownership Requirement.--At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. * * *

5/ SEC. 543. PERSONAL HOLDING COMPANY INCOME.

(a) General Rule.--For purposes of this subtitle, the term "personal holding company income" means the portion of the adjusted ordinary gross income which consists of:

* * * * *

calculation of which, in turn, requires the prior computation of first, gross income, and then, "ordinary gross income". Section 61 and the Regulations thereunder govern the determination of gross income, Treas. Regs., sec. 1.542-2, the amounts of which here are not disputed by the parties. "Ordinary gross income" is defined in section 543(b)(1)[6/] as the gross income determined by excluding capital gains,

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6/ SEC. 543. PERSONAL HOLDING COMPANY INCOME.

* * * * *

(b) Definitions.--For purposes of this part --

(1) Ordinary Gross Income.--The term "ordinary gross income" means the gross income determined by excluding --

(A) all gains from the sale or other disposition of capital assets,

(B) all gains (other than those referred to in subparagraph (A)) from the sale or other disposition of property described in section 1231(b), and

(C) in the case of a foreign corporation all of the outstanding stock of which during the last half of the taxable year is owned by nonresident alien individuals (whether directly or indirectly through foreign estates, foreign trusts, foreign partnerships, or other foreign corporations), all items of income which would, but for this subparagraph, constitute personal holding company income under any paragraph of subsection (a) other than paragraph (7) thereof.

section 1231(b) gains, and certain additional amounts in the case of a foreign corporation. By reason of section 543(b)(2),[7] ordinary gross income becomes "adjusted ordinary gross income" by

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6/ Continued

Section 543(b)(1) was amended by section 104(h)(2)(C) of the Foreign Investors Tax Act of 1966, Pub. L. 89-809, approved November 13, 1966, by the addition of subparagraph (C). This amendment was made applicable with respect to taxable years beginning after December 31, 1966.

7/ SEC. 543. PERSONAL HOLDING COMPANY INCOME.

* * * * *

(b) Definitions.--For purposes of this part --

* * * * *

(2) Adjusted Ordinary Gross Income.--The term "adjusted ordinary gross income" means the ordinary gross income adjusted as follows:

(A) Rents.--From the gross income from rents (as defined in the second sentence of paragraph (3) of this subsection) subtract the amount allowable as deductions for --

(i) exhaustion, wear and tear, obsolescence, and amortization of property other than tangible personal property which is not customarily retained by any one lessee for more than three years,

(ii) property taxes,

(iii) interest, and

(iv) rent,

excluding from it the amounts of certain deductions allocable to rental income and

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7/ Continued

to the extent allocable, under regulations prescribed by the Secretary or his delegate, to such gross income from rents. The amount subtracted under this subparagraph shall not exceed such gross income from rents.

(B) Mineral Royalties, Etc.--From the gross income from mineral, oil, and gas royalties described in paragraph (4), and from the gross income from working interests in an oil or gas well, subtract the amount allowable as deductions for --

(i) exhaustion, wear and tear, obsolescence, amortization, and depletion,

(ii) property and severance taxes,

(iii) interest, and

(iv) rent,

to the extent allocable, under regulations prescribed by the Secretary or his delegate, to such gross income from royalties or such gross income from working interests in oil or gas wells. The amount subtracted under this subparagraph with respect to royalties shall not exceed the gross income from such royalties, and the amount subtracted under this subparagraph with respect to working interests shall not exceed the gross income from such working interests.

to mineral, oil and gas royalties[8/] plus the amount of interest derived from several specified sources. And under section 543(a), the term "personal holding company income" means, as far as is relevant here, that portion of the adjusted ordinary gross income which consists of, among other items:

7/ Continued

(C) Interest.--There shall be excluded--

(i) interest received on a direct obligation of the United States held for sale to customers in the ordinary course of trade or business by a regular dealer who is making a primary market in such obligations, and

(ii) interest on a condemnation award, a judgment, and a tax refund.

(D) Certain Excluded Rents.--From the gross income consisting of compensation described in subparagraph (D) of paragraph (3) subtract the amount allowable as deductions for the items described in clauses (i), (ii), (iii), and (iv) of subparagraph (A) to the extent allocable, under regulations prescribed by the Secretary or his delegate, to such gross income. The amount subtracted under this subparagraph shall not exceed such gross income.

8/ With respect to mineral royalties, the amount remaining after the exclusion of the enumerated deductions is defined as "adjusted income from mineral, oil, and gas royalties". Section 543(b)(4).

(3) Mineral, Oil, and Gas Royalties.--The adjusted income from mineral, oil, and gas royalties; except that such adjusted income shall not be included if--

(A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income.

(B) the personal holding company income for the taxable year (computed without regard to this paragraph, and computed by including as personal holding company income copyright royalties and the adjusted income from rents) is not more than 10 percent of the ordinary gross income, and

(C) the sum of the deductions which are allowable under section 162 (relating to trade or business expenses) other than--

(i) deductions for compensation for personal services rendered by the shareholders, and

(ii) deductions which are specifically allowable under sections other than section 162,

equals or exceeds 15 percent of the adjusted ordinary gross income.

Once again, it is the purpose of these successive computations to arrive at the corporation's "adjusted ordinary gross income" and its "personal holding company income", the two components by which a personal holding company is identified in section 542(a)(1).

Royalty Income Issue. It is petitioner's primary contention that its agreement with Jamieson Company effected a sale of its entire interest in the sand and gravel deposits, the proceeds of which were capital gains rather than royalties. On this basis it reasons that the income from that sale was not a part of its ordinary gross income and therefore did not contribute either to adjusted ordinary gross income or to personal holding company income. The parties agree that if the proceeds were capital gain, petitioner is not subject to the personal holding company tax because it failed to meet the 60 percent requirement upon which classification under section 542(a)(1) as a personal holding company is predicated. The Commissioner, however, takes exception to petitioner's conclusion as to the nature of the sand and gravel income. It is the Commissioner's contention that this was ordinary income derived from mineral royalties. It therefore constituted ordinary gross income, and, because it was mineral royalty income, it also entered into the computation of both adjusted ordinary gross income under section 543(b)(2)(B) and personal holding company income by reason of section 543(a)(3).

Alternatively, petitioner takes the position that, for the taxable years ended in 1967 and 1969, even if the proceeds in question were mineral royalties, petitioner otherwise met the three conditions of section 543(a)(3) for which reason the mineral royalty income was not includable in its personal holding company income, and its remaining personal holding company income did not amount to 60 percent of its adjusted ordinary gross

income. In this regard, petitioner argues that the California franchise and real property taxes which it paid were not "deductions which are specifically allowable under sections other than section 162", as provided in section 543(a)(3)(C)(ii), with the result that its section 162 deductions exceeded 15 percent of its adjusted ordinary gross income, even including the mineral royalties. The Commissioner here disputes not only the mathematics involved in petitioner's allocation of such taxes, but more basically, he denies that they fell beyond the reach of section 543(a)(3)(C)(ii) inasmuch as they were specifically deductible by reason of section 164. We hold in favor of the Commissioner.

Whether a taxpayer is entitled to capital gains treatment upon the sale of sand, gravel and the like is a familiar question with which the courts have wrestled seemingly all too often. From the plethora of opinions on this subject has emerged the now widely accepted principle by which the facts of each case are to be measured. Often referred to as the "economic interest" test, it was first propounded by the Supreme Court in Palmer v. Bender, 287 U.S. 551, with respect to the depletion allowance for oil and gas. In order to be eligible for that deduction, the taxpayer must have held an economic interest in the mineral property, the required evidence of which was that the taxpayer (1) acquired an interest therein through investment, and (2) secured income derived solely from the mineral extraction "to which he must look for a return of his capital." 287 U.S. at 557.

The extension of this criterion to the taxation of proceeds from the extraction of hard minerals may be stated as follows: if the property owner disposes of his entire interest in the deposits "in place", unconditionally and without further interest in their removal, then his income therefrom is not disqualified from being regarded as capital gain by reason of the form of the transaction however, where the terms of the agreement are tantamount to a lease for the exploitation of the land whereby the property owner must look to the extraction of the mineral in order to recover his capital, then the owner has retained an economic interest in the deposits and in their production which interest renders the gain reflected in the proceeds therefrom ordinary income in his hands. Alkire v. Riddell, 397 F. 2d 779, 780 (C.A. 9); Hair v. Commissioner, 396 F. 2d 6, 8 (C.A. 9), affirming a Memorandum Opinion of this Court; Hartman Tobacco Company v. United States, 471 F. 2d 1327, 1329-30 (C.A. 2); Laudenslager v. Commissioner, 305 F. 2d 686, 690-91 (C.A. 3), affirming a Memorandum Opinion of this Court; Cox v. United States, 497 F. 2d 348, 350 (C.A. 4); Wood v. United States, 377 F. 2d 300, 304-5 (C.A. 5), certiorari denied, 389 U.S. 977; Gitzinger v. United States, 404 F. 2d 191, 193 (C.A. 6); Schreiber v. United States, 382 F. 2d 553, 554 (C.A. 7); Dingman v. United States, 429 F. 2d 70, 72 (C.A. 8); Samuel L. Green, 35 T.C. 1065.

Where, as here, it is not disputed that petitioner acquired an interest in the deposits through investment, the key consideration is the basis upon which it recouped that investment, or stated other-

wise, did petitioner "look solely to the extraction of * * * [minerals] for a return of * * * [its] capital". Commissioner v. Southwest Expl. Co., 350 U.S. 308, 314. If so, then the proceeds were royalties as that term is defined in the Regulations and by this Court. Treas. Regs., sec. 1.543-1(b)(3); U.S. Universal Joints Co., 46 B.T.A. 111, 116.

The answer to the question depends largely upon an evaluation of the particular facts involved. Moreover, as in tax matters of every sort, unless otherwise clearly provided by statute, we must be guided by the substance of the underlying arrangement, not by its formal trappings. Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 266-67; Rutledge v. United States, 428 F. 2d 347, 352 (C.A. 5); Royalton Stone Corporation v. Commissioner, 379 F. 2d 298, 299 (C.A. 2), affirming a Memorandum Opinion of this Court: Estate of Ollie G. Rose, 56 T.C. 185, 190. And in applying these principles to the present problem, "[t]he determination of whether an economic interest has been retained is not dependent upon the label that is given to the transaction by the parties * * *". Laudenslager v. Commissioner, supra, 305 F. 2d at 690. Thus, "[the] economic interest test is not affected by the fact that the agreement was written as a sale rather than as a mineral lease." Hartman Tobacco Company v. United States, supra, 471 F. 2d at 1329.

The substance of the arrangement between petitioner and Jamieson Company convinces us that petitioner did retain an economic interest in its sand and

gravel deposits for which reason the payments received from Jamieson Company are royalties. Although the parties adopted the language of an outright sale in one portion of their agreement, this was nothing more than protective coloration, and was contradicted by other provisions therein. The heart of their arrangement was contained in the terms of paragraph 3, where they provided that Jamieson Company was to pay petitioner a specified amount for each ton of rock, gravel or sand removed. This was the only consideration for the sand and gravel. Moreover, the amount so specified was based on a sliding scale of prices per ton pegged to the average wholesale price during the month of removal. Accordingly, the agreed upon payments to petitioner were entirely dependent upon Jamieson Company removing the sand and gravel. The contract provided for no down payment, no guaranteed minimum payment, no ceiling on payments and no other compensation. Cf. United States v. White, 311 F. 2d 399 (C.A. 10); Gowans v. Commissioner, 246 F. 2d 448 (C.A. 9); Don C. Day, 54 T.C. 1417. Indeed, by tying the price of the sand and gravel to current market conditions, the agreement underscored petitioner's ongoing stake in the extraction and sale of those deposits. We can hardly imagine a clearer instance of a retained economic interest. The only real sales occurred as the gravel was severed from the land ton by ton and paid for at a price geared to current market conditions. There was no sale of the material "in place" at the time of execution of the agreement.

Our conclusion in this respect is confirmed, we think, by the language of

the 1962 addendum to the contract which provided that the "purchase price" would be reduced by 20 percent in any year in which petitioner "sold" more than a million tons of rock, sand and gravel to Jamieson Company. By its agreement to this price reduction as an incentive for Jamieson Company's increased production, petitioner attested to the explicitly conditional nature of its recovery of its investment. Plainly, it was the parties' understanding that their arrangement involved continuing and repeated royalty payments in respect of the sand and gravel as they were removed rather than a single, unconditional sale of the deposits "in place" to be paid for either in a lump sum or by installments.

Petitioner nonetheless argues that Jamieson Company's obligation under the contract to remove all of the deposits on petitioner's land was unconditional and enforceable in court, as a result of which petitioner would have us conclude that the payments under the contract were not dependent upon the extraction as such but were rather in the way of installments on a single purchase price which, on account of the uncertain extent of the deposits, could not be ascertained at the outset.

This interpretation of the contract, however, fails to account for the percentage-of-market price arrangement and for the agreement to grant Jamieson Company production discounts, both of which smack of a retained economic interest by petitioner. The broader response to petitioner's position, though, is that nowhere in the contract was Jamieson Company obligated to remove any deposits. To be sure,

it was contemplated that it would remove some deposits. The contract included an estimate of available deposits, qualified, however, by a specific disclaimer of any warranty in respect thereof. But paragraph 1 spoke only of a "right" to quarry on the premises, and then only "as may be proper and profitable under good quarrying practices". Furthermore, paragraph 4 provided Jamieson Company with an option to terminate the agreement if "at any time * * * Buyer determines that rock, gravel and sand can no longer be profitably quarried and removed from the lands * * * ". This is not the language of an unconditional obligation. Cf. Estate of Walker v. Commissioner, 464 F. 2d 75 (C.A. 3); Royalton Stone Corporation v. Commissioner, supra, 379 F. 2d 298 (C.A. 2). Quite the contrary, by reason of this escape clause, petitioner's prospect of receiving payments was wholly dependent upon Jamieson Company determining that market conditions were favorable. This circumstance alone, apart from other considerations, serves to distinguish this case from Wayman A. Collins, 56 T.C. 1074, upon which petitioner relies. Even with respect to the estimated deposits, it is clear that their actual presence or absence was immaterial insofar as Jamieson Company's obligation to mine them was concerned.

In this regard it appears to us that petitioner's true role in this arrangement was that of a co-stakeholder with Jamieson Company in the deposits, both of whom bore the risk of a poor market and shared the gains in a favorable market. The contingent nature of petitioner's compensation resembled the situation in Hair v. Commissioner, supra, 396 F. 2d 6 (C.A. 9), in

which the purchaser was not obligated to remove all of the sand and gravel from the property. On that basis the Court distinguished the situation with which it had dealt in Gowans v. Commissioner, supra, concluding that (at pp. 8-9):

> Where, as here, taxpayers [sic] only substantive return of capital is dependent upon a unit price payment for an undetermined amount of sand and gravel, to be paid if, as and when removed, they have retained an economic interest. [Emphasis supplied.]

See also Alkire v. Riddell, supra, 397 F. 2d 779, 780 (C.A. 9).

By reason of the conditional payment arrangement here and the absence of an obligation of Jamieson Company to remove all, or indeed any, of the sand and gravel deposits, we are fully persuaded that under the agreement petitioner looked solely to the extraction of the deposits for a return of its investment in the land. Petitioner thus retained an economic interest in the property in the form of royalty payments, the fact of which belies the existence of a sale of the deposits "in place". This conclusion in respect of the form of the transaction relieves us of the necessity of deciding whether the sand and gravel deposits could properly be deemed a capital asset in the hands of petitioner, although the answer seems fairly clear since the corporation was engaged in the business of selling sand and gravel. Cf. Corn Products Co. v. Commissioner, 350 U.S. 46. On account of the foregoing, we hold that petitioner's

gross income from such sales was properly reported by petitioner as ordinary income and that petitioner is therefore not entitled to a refund. Accordingly, its income from gravel sales was includable in the computation of its ordinary gross income and its adjusted ordinary gross income under section 543(b)(1) and (2). It is also includable in petitioner's personal holding company income under section 543(a)(3) unless petitioner has met the terms of the cumulative three-part exception contained therein.

To repeat, under the pertinent statutory provision of section 543(a)(3), personal holding company income means the portion of adjusted ordinary gross income which consists of, among other items,

> (3) Mineral, Oil, and Gas Royalties.--The adjusted income from mineral, oil and gas royalties; except that such adjusted income shall not be included if--
>
> (A) such adjusted income constitutes 50 percent or more of the adjusted ordinary gross income.
>
> (B) the personal holding company income for the taxable year (computed without regard to this paragraph, * * *) is not more than 10 percent of the ordinary gross income, and
>
> (C) the sum of the deductions which are allowable under section 162 (relating to trade or business expenses) other than --

(i) deductions for compensation for personal services rendered by the shareholders, and

(ii) deductions which are specifically allowable under sections other than section 162,

equals or exceeds 15 percent of the adjusted ordinary gross income. [Emphasis supplied.]

The parties agree that petitioner did not in any event comply with the 10 percent test of part (B) for the taxable year ended in 1968. Furthermore, unless petitioner was entitled to include its California franchise and real property taxes in its computations under (C), it cannot avail itself of the exception for the remaining two years in issue. The California franchise tax is a tax levied on net income, Cal. Rev. & Tax Code, section 23151 (West 1970), and is specifically deductible under section 164(a)(3) of the Code; state property taxes are specifically deductible under section 164(a)(1). Therefore neither tax may be considered for purposes of the test under section 543(a)(3)(C). Thus, regardless of whether petitioner otherwise satisfied the conditions of section 543 (a)(3)(A) and (B) for the taxable years ended in 1967 and 1969, we hold that it failed to meet the requirement of part (C) in both years.

Petitioner's reliance on our decision in McNutt-Boyce Co. 38 T.C. 462, affirmed 324 F. 2d 957 (C.A. 5), is misplaced inasmuch as Congress prospectively reversed the result reached in that case

by enacting sections 542(c)(6)(C) and 542(d)(2)(A) in 1964. Section 225(c) of the Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19, pp. 80-81. See H. Rept. No. 749, 88th Cong., 1st Sess., p. A92. Likewise, section 543(a)(3), formerly section 543(a)(8), was amended at that time by the introduction of the language now contained in (C)(ii). Section 225(d) of the Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19, p. 82. See H. Rept. No. 749, 88th Cong., 1st Sess., p. A95. Cf. ibid, p. A97 with respect to similar language added to section 543(a)(4)(C). The statute is now too clear with respect to the exception to require further discussion. We therefore conclude that because the exception provided in section 543(a)(3) is not available to petitioner,[9/] there is no reason not to include its adjusted income from mineral royalties in its personal holding company income, as a result of which petitioner is a personal holding company within the meaning of section 542(a) for all three of the years here involved and is subject to the tax imposed by section 541.

Procedural Issues.

1. Statute of Limitations. Petitioner nonetheless maintains that collection of the deficiencies determined by the

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9/ Since we find that there has been failure of compliance with condition (C) of section 543(a)(3), it is unnecessary to consider petitioner's contention in respect of alleged compliance with the 10 percent requirement of condition (B) for the taxable year ended in 1969.

Commissioner is barred by reason of the Commissioner's disregard of two procedural requirements. The first of these alleged errors pertains to the mailing of the notice of deficiency, which, petitioner points out, occurred more than three years after January 16, 1970, the date on which it filed its return for the most recent of the years in issue. Petitioner concludes that the assessment and collection of the deficiencies herein is barred by section 6501(a),[10] the applicability of which to personal holding company taxes, says petitioner, is not affected by petitioner's consent to an extension of the period of limitation upon the assessment of "income and profits tax".

The short answer to petitioner's position is that the applicability of section 6501(a) is expressly subject to the other provisions of section 6501, among which is the following:

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[10] SEC.6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.

(a) General Rule.--Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) or, if the tax is payable by stamp, at any time after such tax became due and before the expiration of 3 years after the date on which any part of such tax was paid, and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.

(f) Personal Holding Company Tax.-- If a corporation which is a personal holding company for any taxable year fails to file with its return under chapter 1 for such year a schedule setting forth --

(1) the items of gross income and adjusted ordinary gross income, described in section 543, received by the corporation during such year, and

(2) the names and addresses of the individuals who owned, within the meaning of section 544 (relating to rules for determining stock ownership), at any time during the last half of such year more than 50 percent in value of the outstanding capital stock of the corporation.

the personal holding company tax for such year may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return for such year was filed.

In each of the years in issue petitioner filed a standard U.S. Corporation Income Tax Return, Form 1120, unaccompanied by the schedule of specific information referred to in section 6501(f). Petitioner nevertheless contends that section 6501(f) is inapplicable because all of the information sought therein was contained in petitioner's returns, albeit not on a separate schedule. This position is simply untenable.

In the first place, nowhere did petitioner provide the Commissioner with its adjusted ordinary gross income or even all the information necessary for its computation.11/ This particular item was considered to be of sufficient importance that its specific mention was added to section 6501(f) by amendment in 1964. Revenue Act of 1964, Pub. L. 88-272, 88th Cong., 2d Sess., sec. 225(k)(6). Moreover, even if petitioner had reported its adjusted ordinary gross income in the same inconspicuous manner in which it included the other information pertaining to its gross income, petitioner could not be regarded as having complied with section 6501(f). Although the Supreme Court in Commissioner v. Lane-Wells Co., 321 U.S. 219, was dealing with a requirement then in effect regarding the filing of a separate return for personal holding companies on Form 1120 H notwithstanding that all pertinent information may have been reported in the regular corporate return on Form 1120, its reasoning is equally applicable here in respect of the present requirement that a separate schedule

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11/ In computing the adjusted ordinary gross income, as defined in section 543(b)(2), it is necessary, in respect of mineral royalties, to subtract therefrom the amount of certain deductions "to the extent allocable * * * to such gross income from royalties." Inasmuch as petitioner received income from sources other than mineral royalties, such an allocation may have been necessary. Yet, on its return petitioner did not indicate whether such an allocation was required nor did it provide the information on which to base such an allocation.

(specifically identified in the Forms 1120 in use in the taxable years as Schedule 1120 PH) be filed along with Form 1120. The Court made clear that the purpose of requiring that the pertinent information be set forth separately (321 U.S. at 223)

> is not alone to get tax information in some form but also to get it with such uniformity, completeness, and arrangement that the physical task of handling and verifying returns may be readily accomplished.

Not only did petitioner fail to include this information in a readily usable fashion, it effectively disguised what information was reported by failing to check the box provided on its Form 1120 identifying itself as a personal holding company. Cf. Mayfair Minerals, Inc., 56 T.C. 82, 92, affirmed 456 F. 2d 622 (C.A. 5).

Statutes which bar the collection of taxes otherwise due and unpaid are matters of Congressional consent and are to be strictly construed in favor of the Government. Lucia v. United States, 474 F. 2d 565, 570 (C.A. 5); McDonald v. United States, 315 F. 2d 796, 801 (C.A. 6); Pacific Coast Steel Co. v. McLaughlin, 61 F. 2d 73, 75 (C.A. 9); Loewer Realty Co. v. Anderson, 31 F. 2d 268, 269 (C.A. 2). Petitioner has clearly failed to comply with the explicit return requirement of section 6501(f) for which reason the applicable period of limitations is six years. The deficiency notice herein was therefore timely mailed. West Coast Ice Co., 49 T. C. 345, 350. On account of the applicability of section 6501(f), we do not reach the question raised by petitioner as to

the breadth of the consent obtained by the Commissioner by reason of an executed Form 872 which covered "any Federal income and profits taxes due" under any return made by the taxpayer.

2. Second Examination. The second of petitioner's procedural objections concerns the alleged second audit of its returns for the taxable years ended October 31, 1967, and 1968, both of which were stamped "CLOSED ON SURVEY", on account of which petitioner argues the deficiencies determined in respect of those years are void. Petitioner's authority for such a conclusion is unclear. Section 7605(b)[12/] and the accompanying regulations (section 301.7605-1) upon which it relies, are inapposite inasmuch as the parties have stipulated that the Commissioner conducted only one actual inspection of petitioner's books, and it is well settled that that section has no bearing upon the Commissioner's authority to examine tax returns already in his possession. Cf. United States v. Dawson,

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12/ SEC. 7605. TIME AND PLACE OF EXAMINATION.

* * * * *

(b) Restrictions on Examination of Taxpayer.--No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary or his delegate, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

400 F. 2d 194, 200 (C.A. 2); Geukink v. United States, 354 F. 2d 629, 631 (C.A. 7); DeMasters v. Arend, 313 F. 2d 79, 85-86 (C.A. 9); Robert F. Collins, 61 T.C. 693.

Likewise, petitioner's reliance upon section 601.105(j)[13/] Proced. & Admin. Regs., is misplaced. Those regulations are intended to govern the

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13/ SEC. 601.105. EXAMINATION OF RETURNS AND CLAIMS FOR REFUND, CREDIT OR ABATEMENT; DETERMINATION OF CORRECT TAX LIABILITY.

* * * * *

(j) Reopening of cases closed after examination.

(1) The Service does not reopen any case closed after examination by a district office or Office of International Operations to make an adjustment unfavorable to the taxpayer unless;

(i) There is evidence of fraud, malfeasance, collusion, concealment, or misrepresentation of a material fact; or

(ii) The prior closing involved a clearly defined substantial error based on an established Service position existing at the time of the previous examination; or

(iii) Other circumstances exist which indicate failure to reopen would be a serious administrative omission.

reopening of cases which are closed after examination. The two returns in controversy at this point were not previously "examined" at all. They were merely checked for form, execution, mathematical accuracy, and were "surveyed" for classification. As a result of that "survey" it was determined that they would not be "examined" -- i.e., that there would not be either a field audit or an office audit --, and the words "CLOSED ON SURVEY" were then stamped on the face of the returns to reflect such classification. See sections 601.103(b) and 601.105(a), Proced. & Admin. Regs.[14] That "survey"

13/ Continued

(2) All reopenings are approved by the Assistant Regional Commissioner (Audit), or by the Director of International Operations for cases under his jurisdiction. If an additional inspection of the taxpayer's books of account is necessary, the notice to the taxpayer required by Code section 7605(b) will be delivered to the taxpayer at the time the re-examination is begun.

14/ Sec. 601.103(b), Proced. & Admin. Regs., provides as follows:

SEC. 601.103. SUMMARY OF GENERAL TAX PROCEDURE.

* * * * *

(b) Examination and determination of tax liability. After the returns are filed in the office of the district director of internal revenue or in the office

or "classification" was not an "examination" within the meaning of section 601.105(j), and that this is the proper meaning to be given the word "examination" as thus used is made clear by the context in which the matter is treated in Revenue Procedure 72-40, 1972-2 C.B. 819-820, which is concerned with "agreed" and "unagreed" cases, situations that obviously contemplate the conduct of

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14/ Continued

of the director of a regional service center, they are sorted, classified, and processed. Many of these returns are selected for examination. If adjustments are proposed with which the taxpayer does not agree, he is ordinarily afforded certain appeal rights, including an opportunity to discuss the proposed adjustments (except mathematical errors) in a conference in the district director's office. If this conference results in agreement on the proposed adjustments, the taxpayer is requested to execute an agreement form. If the tax involved is an income, profits, estate, gift, or chapter 42 tax, and if the taxpayer waives restrictions on the assessment and collection of the tax (see sec. 601.105(b), the deficiency will be immediately assessed.

Similarly, section 601.105(a) contemplates a preliminary check on returns prior to the examination alluded to in part (j):

> Sec. 601.105 Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

audits and conferences with the taxpayer or his representatives. There has thus been no closing of the cases after "examination" within the meaning of the regulations,[15] and therefore the reopening procedure provided for in section 601.105(j) is inapplicable. More-

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14/ Continued

(a) Processing of returns. When the returns are filed in the office of the district director of internal revenue or the office of the director of a regional service center, they are checked first for form, execution, and mathematical accuracy. Mathematical errors are corrected and a correction notice of any such error is sent to the taxpayer. Notice and demand is made for the payment of any additional tax so resulting, or refund is made of any overpayment. Returns are classified for audit at regional service centers. Certain individual income tax returns with potential unallowable items are delivered to Audit Divisions at regional service centers for correction by correspondence. Otherwise, returns with the highest audit potential are delivered to district Audit Divisions based on workload capacities. Those most in need of examination are selected for office or field audit.

15/ Cases closed after examination are to be distinguished from cases in respect of which the taxpayer and the Commissioner have executed a closing agreement the exclusive procedure for which is set forth in section 7121. That section

over, and finally, these procedural rules are merely directory, and like other similar procedural rules "compliance with them is not essential to the validity of a notice of deficiency". Luhring v. Glotzbach, 304 F. 2d 560, 563 (C.A. 4). Accord, Cleveland Trust Co. v. United States, 421 F. 2d 475, 481-482 (C.A. 6); Geurkink v. United States, supra, 354 F. 2d 629, 632 (C.A. 7); Robert F. Collins, supra, 61 T.C. 693, 701; Anthony B. Cataldo, 60 T.C. 522, 523; Philip F. Flynn, 40 T.C. 770, 773.

Decision will be entered

for the respondent.

15/ Continued

envisages an agreement knowingly entered into by both parties. Estate of Ella T. Meyer, 58 T.C. 69, 71; H. M. Harrington, Sr., 48 T.C. 939, 953, affirmed on another issue, 404 F. 2d 237 (C.A. 5). Here no such agreement was entered into nor does petitioner contend so.

APPENDIX B

UNITED STATES COURT OF APPEAL

FOR THE NINTH CIRCUIT

PLEASANTON GRAVEL COMPANY, Petitioner,	)	
v.	)	No. 75-2730
COMMISSIONER OF INTERNAL REVENUE, Respondent.	)	

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

Before: DUNIWAY, SNEED and TANG, Circuit Judges

PER CURIAM

The judgment of the Tax Court is affirmed for the reasons stated in the Opinion of Judge Raum, 64 T.C. 510 (1975).

AFFIRMED

Supreme Court, U. S.
FILED
DEC 7 1978
MICHAEL RODAK, JR., CLERK

No. 78-660

In the Supreme Court of the United States

OCTOBER TERM, 1978

PLEASANTON GRAVEL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATFS COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530

In the Supreme Court of the United States

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PLEASANTON GRAVEL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

The sole question presented in this federal income tax case is whether income petitioner received under a mineral lease agreement is royalties and therefore taxable as personal holding company income under Section 543(a)(3) of the Internal Revenue Code of 1954.

The pertinent facts may be summarized as follows: Petitioner, a corporation wholly owned by George Jamieson, purchased a tract of land from Jamieson in 1956. In 1959, petitioner and Jamieson Company, a partnership owned by George Jamieson and his father, entered into an agreement under which Jamieson Company was granted the right to extract rock, sand and gravel from petitioner's tract of land. Jamieson Company agreed to pay petitioner five cents per ton of rock, sand and gravel removed, plus an additional one cent per ton for each thirty cent increment by which the local

wholesale price exceeded $1.50 per ton.[1] The agreement contained no provisions for a minimum payment, minimum quantities of minerals to be extracted, or any other fixed obligation on the part of Jamieson Company. Jamieson Company retained the right to terminate the agreement, on 60 days notice, "[i]f at any time during quarrying operations Buyer [Jamieson Company] determines that rock, gravel and sand can no longer be profitably quarried and removed from the lands described in 'Exhibit A' hereto * * *" (Pet. App. 5).

On audit, the Commissioner of Internal Revenue determined that the income petitioner received from the gravel transfers was royalties and that petitioner was therefore a personal holding company under Section 542 of the Code because more than 60 percent of its adjusted ordinary gross income was personal holding company income. In response, petitioner took the position that it should have reported the income in question as capital gains and claimed refunds for each of the years at issue (Pet. App. 11).

The Tax Court held that under this Court's decision in *Palmer* v. *Bender*, 287 U.S. 551 (1933), petitioner retained an "economic interest" in the minerals excavated from its land so that any income derived under the agreement with Jamieson Company was not capital gain but royalties. It therefore upheld the Commissioner's determination that petitioner was a personal holding company (Pet. App. 19-29). The court of appeals affirmed per curiam (Pet. App. 40).

1. Petitioner contends (Pet. 4-5) that the decision below misapplied the economic interest test set forth in *Palmer* v. *Bender*, *supra*. There, the Court held that the taxpayer

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[1]In 1962, the parties amended the agreement to provide that Jamieson Company would receive a volume discount when more than one million tons were quarried in a given year (Pet. App. 6-7).

retains an economic interest in minerals[2] in place by investment[3] if it looks "*solely* to the extraction of * * * [the minerals] for a return of [its] capital." *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308, 314 (1956). See Treasury Regulations, Section 1.611-1 (26 C.F.R.).

Here, the agreement between petitioner and Jamieson Company shows that petitioner looked "*solely* to the extraction of * * * [the minerals] for a return of [its] capital." The only measure of petitioner's income was the amount of rock, sand and gravel excavated by Jamieson Company. Jamieson Company was under no obligation to extract any minimum amount of sand and gravel, was under no obligation to make any payment if it did not extract any minerals, and was free to terminate the agreement whenever it appeared that continued excavation would be unprofitable (Pet. App. 5). The provisions of the agreement convincingly refute petitioner's assertion (Pet. 4, 7) that there was an "unconditional sale" of the minerals.[4]

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[2]Although *Palmer* v. *Bender*, *supra*, involved oil and gas production, it is well established that the economic interest test likewise applies to the extraction of hard minerals. *Hartman Tobacco Co.* v. *United States*, 471 F. 2d 1327 (2d Cir. 1973) (en banc); *Oliver* v. *United States*, 408 F. 2d 769 (4th Cir. 1969); *Gitzinger* v. *United States*, 404 F. 2d 191 (6th Cir. 1968); *United States* v. *White*, 401 F. 2d 610 (10th Cir. 1968) (en banc); *Alkire* v. *Riddell*, 397 F. 2d 779 (9th Cir. 1968); *Schreiber* v. *United States*, 382 F. 2d 553 (7th Cir. 1967); *Wood* v. *United States*, 377 F. 2d 300 (5th Cir.), cert. denied, 389 U.S. 977 (1967). See also *Laudenslager* v. *Commissioner*, 305 F. 2d 686 (3d Cir. 1962); *Rabiner* v. *Bacon*, 375 F. 2d 537 (8th Cir. 1967).

[3]It is undisputed that petitioner acquired its interest by investment when it purchased the land from George Jamieson.

[4]The fact that the agreement here spoke of the transaction as a sale, and labeled the parties as "Buyer" and "Seller," is irrelevant. It is the substance, not the form, of the transaction which is controlling for tax purposes. *E.g.*, *Wood* v. *United States*, *supra*, 377 F. 2d at 311; *Royalton Stone Corp.* v. *Commissioner*, 379 F. 2d 298 (2d Cir.), cert. denied, 389 U.S. 978 (1967); *Oliver* v. *United States*, *supra*.

Petitioner further errs in contending (Pet. 6) that the rule of *Palmer* v. *Bender* is limited to those cases where the taxpayer obligates himself to permit the extraction of something less than 100% of the minerals on his land. Quite to the contrary, the economic interest test turns on whether the taxpayer's income is measured solely by the extraction of the minerals in place, without regard to a fixed total amount of minerals to be extracted. *Wood* v. *United States, supra.* See *Hartman Tobacco Co.* v. *United States, supra; Laudenslager* v. *Commissioner,* 305 F. 2d 686 (3d Cir. 1962); *Oliver* v. *United States,* 408 F. 2d 769 (4th Cir. 1969); *Hair* v. *Commissioner,* 396 F. 2d 6 (9th Cir. 1968); *Schreiber* v. *United States,* 382 F. 2d 553 (7th Cir. 1967); *Rabiner* v. *Bacon,* 373 F. 2d 537 (8th Cir. 1967).

2. Contrary to petitioner's further contention (Pet. 4, 6-7), the decision below does not conflict with either *Linehan* v. *Commissioner,* 297 F. 2d 276 (1st Cir. 1961), or *Rhodes* v. *United States,* 464 F. 2d 1307 (5th Cir. 1972). In *Linehan,* the excavator was under an affirmative duty to extract all of the minerals in place to a certain grade, *i.e.,* a fixed amount. Apart from this pivotal distinction, several courts of appeals have criticized *Linehan* on the ground that it failed to apply the economic interest test to hard minerals. See *Hartman Tobacco Co.* v. *United States, supra,* 471 F. 2d at 1329; *United States* v. *White, supra,* 401 F. 2d at 612; *Oliver* v. *United States, supra,* 408 F. 2d at 771; *Alkire* v. *Riddell,* 397 F. 2d 779, 780 (9th Cir. 1968); *Wood* v. *United States, supra,* 377 F. 2d at 309; *Laudenslager* v. *Commissioner, supra,* 305 F. 2d at 692 n.4. See cases cited at page 3, n.2, *supra.*

Rhodes is likewise distinguishable. There, the taxpayer entered into an agreement under which he received a flat $15,000 per two-acre parcel of land for the rights to the clay deposits. Unlike the agreement in this case, the

buyer's obligation in Rhodes was unconditional and the amount to be paid was in no manner dependent upon the extraction of the minerals in place.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

DECEMBER 1978

DOJ-1978-12

Supreme Court, U. S.
FILED
DEC 30 1978
MICHAEL RODAK, JR., CLERK

IN THE

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October Term, 1978

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Petitioner,

v.

COMMISSIONER OF THE INTERAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE PETITIONER IN REPLY

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Palmer v. Bender, 287 U.S. 551 (1933) was decided 45 years ago. The decision set forth an "economic interest" test to be used in oil and gas production leases specifically to determine to whom the depletion allowance would be available.

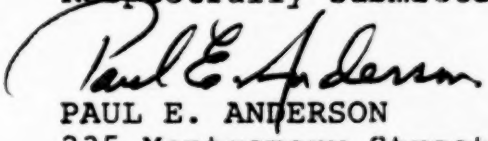
The test was not to determine whether or not there had been a "sale or exchange" within the purview of the capital gains provisions. In the sense that Palmer v. Bender

created a lease out of a sale, it is wrong.

What is an "economic interest" in a sale? Do we use language of a "lease" to make a sale? How do you make a sale where sound business practice indicates that in no way could a reasonably certain price be fixed at the outset?

Upon entering the agreement involved herein, the taxpayer sold ALL mineable quantities of gravel -- from this point on he could no longer transfer this right to anyone else. If this complete divestiture of interest is not a sale, what is?

Respectfully submitted,



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